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Owner/Managers' External Financing Used and Preference towards Islamic Banking

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***Abstract*—**Economic development and growth are significantly linked to the consistent and sustainable sector of small and medium enterprises (SMEs). Banks are the frontrunners in financing and advising SMEs. The main objective of the study is to assess the tendency of SMEs to use the Islamic bank. Model was developed using quantitative method with a hypothetical-deductive testing approach. Model (N = 364) used primary data on the tendency of SMEs to use Islamic banks gathered from questionnaire. It is found by Mann-Whitney test that the tendency to use Islamic bank varies between those firms which consider formal financing with the ones relying on informal financing with the latter tends more to use Islamic bank. This study can serve academic researchers, policy makers, and developing countries as a model of SMEs' desirability to Islamic banking.

***Keywords*—**Formal financing, informal financing, Islamic bank, SMEs.

I. Introduction

ACCESS to use of financial services by enterprises is of increasing concern to policy makers across developing countries.The financing of small and medium enterprises (SMEs) has attracted the interest of both policy makers and researchers because of the important projections of these enterprises in the global economic growth [1], [2].

The Libyan economy is currently heading to an economic structural development and an expanded privatization of areas that are commonly controlled by the government. SMEs are the basic and most reliable providers of employment that can drive a country toward its development as a whole. The importance of SMEs to Libya comes with the fact that the Libyan economy suffers from non-diversification of economic activities; mostly concentrated in construction and oil & gas sectors – oil and gas sector constitutes about 70% of the Libyan GDP, over 90% of government revenues, and almost all the country exports except for very few other products like fisheries and dates [3].

Banks are often unable or unwilling to give term loans to SMEs in most developing countries. They prefer to lend to big businesses with well-developed balance sheets and credit histories of additional assets for the collateral required in conventional bank financing [4] which obstructs the access to external formal finance of SMEs. As a result, although 96% of enterprises in Libya are SMEs, their contributions to the gross domestic product (GDP) growth are little at only 4%. The difficulty of these enterprises in acquiring financial loans is considered one of their main problems [5]–[9]. Moreover, Badri [10] finds that 73% of small firms in Libya depend on informal financial sources, and only 11% of the firms are able to acquire bank loans. Similar, Salh, [11] finds that 79% of SMEs in Libya rely on informal finance sources and only 17% used bank loan.

The imposed interests on loans by banks may further limit the access to formal loans of SMEs in Libya. Religious and cultural factors can have a major impact on this issue. Mews and Abraham [12] state that "the world's religious traditions can make significant contributions to contemporary debate". According to the National Program for the Development of Small and Medium Enterprises annual report [13] the lack of Islamic finance makes some entrepreneurs reluctant to complete the procedures after the approval of conventional banks. Other relevant studies have a similar conclusion. [14]-[16] find that most owners of SMEs do not want to obtain loans from conventional banks, such as commercial banks, because they believe that commercial bank loans come with interest, which is prohibited in Islamic law. Therefore, religious has an important role in the search for external financing.

Similar to previous studies on Islamic banking, religion has a significant, positive influence on the adoption of Islamic bank [17]–[28]. However, some studies show that religious is not one of the primary factors that influence customers and firms to use Islamic banks [29]–[34]. In [35], 8 out of the 180 surveyed Malaysian SMEs obtained capital from Islamic banks. 49.3% of the companies obtained initial capital through self-financing, 20.7% through conventional banks, and 7.3% through the financial assistance of governments.

Haron et al. [36] suggest the following:

> "Both Muslims and non-Muslims who patronized commercial banks have a common perception in selecting their banks. With this information, the Islamic bank should not over emphasize, and rely on, the religion factor as a strategy in its effort to attract more customers. The Islamic bank should also be aware that only 40% of Muslims believe that religion is the main factor in why people maintain an account in Islamic banks."

The attitude and perceptions of SMEs toward Islamic banks are important in their consideration of future expansion and development. These attitudes have been widely studied in Muslim and non-Muslim countries, such as Malaysia, Egypt, Jordan, Pakistan, and the United Kingdom. Nonetheless, other countries with Islamic banking where challenges abound must

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also be studied. Libya is one of the many countries that have not yet practiced Islamic banking and finance. A strong possibility exist that Islamic banks and financing will ultimately be established in Libya. Thus, the objective of this paper is to analyze small and medium enterprises SMEs' sources of financing (formal or informal) differences in preference towards Islamic banking

II. Preference of Islamic Banks

Islamic financing benefits the recipient and encourages client loyalty. Business decision making is improved by the ongoing dialogue between the financier and entrepreneur because the two parties work together to produce a superior outcome than when each party works in isolation.

A dramatic increase in Islamic banking is being witnessed globally. The number of Islamic banks amount to over 270 worldwide. The majority of these banks is in the Middle East and Southeast Asia but is also present and plays crucial roles in Europe and the United States [37]–[38]. Assets in Islamic financing have increased by 29% from USD 637 billion in 2008 to USD 825 billion in 2009. This increase indicates a vigorous momentum of remarkable growth [39].

Islamic banking theory is not yet well developed and it requires more studies in a variety of aspects [40]–[41].

The ideology that governs the current economic system of the word is interest oriented, thus resulting in economic disparities, concentration of wealth in the hands of the few, monopolies, and widening gaps between the rich and the poor [42]. Mews and Abraham [43] mention that "Usury is a concept often associated more with religiously based financial ethics, whether Christian or Islamic, than with the secular world of contemporary finance". Thus, the basic principle of Islamic financing is the prohibition of riba (interest). Therefore, Islamic financing has developed methods for clients to accept deposits and lend funds according to the principles of the prohibition of riba. The verses of the Qur'an state the following. "That which you give as interest to increase the people wealth increase not with God; but that which you give in charity, seeking the Goodwill of God, multiplies manifold" (Al-Quran [44], Surah Al-Rum, verse 39). "O believers, take not doubled and redoubled interest, and fear God so that you may prosper. Fear the fire which has been prepared for those who reject faith, and obey God and the prophet so that you may receive mercy" (Al-Quran [45], Surah Al-Imran, verses 130-2). In this context, Islamic financing is the act of providing financial products or services that conforms to Islamic law. Thus, business partners under Islamic law share both profits and losses compared with business partners in the conventional financial system, which relies on the lender–borrower concept.

Islamic banking has emerged as an alternative to conventional banking. Islamic banking aims to cater to the needs of Muslims, who believe that the activities of conventional banks and their religious and moral tenets are incongruent. A study by the World Bank [46] suggests that religious is one of the internal reasons of SME owners in seeking external formal financing. Mahrouq [47] finds that most SME owners do not want to obtain a loan from commercial banks because such loans from come with interests, which is prohibited in Islam. Salh [48] finds that 71% of SMEs owner-manager in Libya refused to borrow from banks because interest is prohibited under Islamic law. Similarly, [49] discovers that the owners-managers of SMEs do not employ bank credits because of their negative attitudes toward conventional banking.

In previous studies, majority of the studies on preference to use Islamic bank are using qualitative approach to measure the religious factor. Religious motivations have been found to have a significant positive influence on the adoption of Islamic banking services [50], [60]. By contrast, some studies have shown that religious motivations are not the sole reason for selecting an Islamic bank [61]–[66]. Ahmad and Haron [67] analyze the attitudes of 45 Malaysian corporate customers toward Islamic banking products and services. They conclude that economic factors such as the profitability and quality of services are more significant for Malaysian corporate customers than religious reasons. Shahrauddain et al. [68] study the perception of SMEs toward Islamic banking products in Malaysia with a sample size of 180 SMEs. They find that Malaysian SMEs do not consider Islamic banks as the most desirable financial institutions either in financing or daily business transactions. A small fraction of surveyed companies, that is, 8 out of 180 companies, obtain their capital from Islamic banks. Shahrauddain et al. [69] suggest that banks should not over emphasize or rely on the religious factor alone as a strategy to attract more customers. Awan and Bukhari [70] find that religious beliefs are less important in selecting Islamic banks in Pakistan.

Given that no adequate studies have been conducted on the attitude of firms toward Islamic banks, Shahrauddain et al. [71] cite a few studies that examine customer behavior toward Islamic banks. Therefore, this study investigates the decision of SME owner-managers in Libya regarding the use of Islamic banking using quantitative approach to identify the SMEs that have the preference to use Islamic bank. As the arguments between firms and the preference to use Islamic bank, we hypothesize that firms that have used conventional bank loans are less likely to choose Islamic banking than firms that have used informal financing. The hypothesis is stated below:

H. Significant differences will exist between firms that have used informal financing and formal financing in the preference to use Islamic banking.

H1. Significant differences will exist between firms that started with conventional bank loan and started with informal financing in the preference to use Islamic banking.

H2. Significant differences will exist between firms that applied bank loan for expansion and firms have never applied bank loan in the preference to use Islamic banking.

H3. Significant differences will exist between firms' loan application form successful and firms' loan application form unsuccessful in the preference to use Islamic banking.

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Thus, firms that have used bank loans have stronger relationships with their banks than firms that have used informal financing. Firms that have used bank loans are also less likely to use Islamic banking than firms that have used informal finance.

III. Conceptual Framework

Conceptual framework for the study is illustrated in Fig 1.

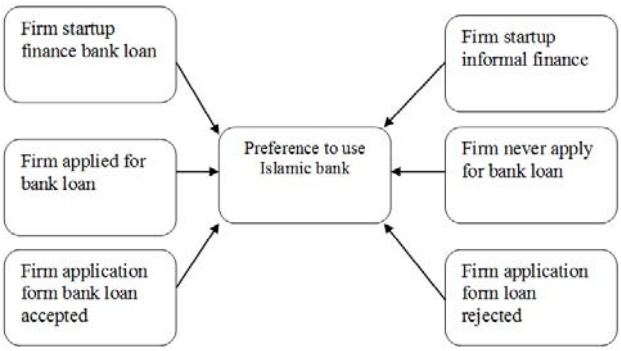


Fig. 1 Model Islamic Bank Preference

IV. Methodology

All firms need financing and the most widely available form of financing is formal financing, which can be obtained from financial institutions such as conventional banks. Otherwise, financing can be obtained from informal financing sources such as family and friends. This study attempts to determine the differences between the financing options available and the preference for Islamic banks. Preference of Islamic banking as a dependent variable is denoted by "1" (willing to use an Islamic bank) or "0" (otherwise).The financing position of a firm as independent variables to identify the preference of firms in using Islamic banking. The independent variables for Islamic bank preference are as follows: (i) Firm startup financing (formal or informal financing) is denoted by "1" (the firm starts with a bank loan) or "0" (otherwise). (ii) Firm expansion financing after the startup stage is denoted by "1" (the firm has applied for a bank loan) or "0" (otherwise). (iii) Loan application status is denoted by "1" (successful) and "0" (rejected). Self-administered questionnaires are the primary tool used in this study for data collection. Non-parametric methods are used specifically for cases when the researcher does not know the parameters of the variable of interest in the population. Therefore, a non-parametric statistical test such as the Mann–Whitney test is chosen over a parametric test to analyze the data because the result of the test data distribution by SPSS-one- sample Kolmgorov-Smirov Test was applied-. The significances of the Kolmgorov-Smirov Test was less than .05 in all test, this implies that data distribution is abnormal. The Mann–Whitney Test is used to determine if any differences exist between firms that have used informal financing and firms that have used bank loans with its preference for Islamic banking.

V. Summary of Data Description

The preceding section presented an overview of the results of SMEs survey data. Based on the data responses a majority of the surveyed SMEs (78.8%) made use of informal financing resource at their start-ups while those who used formal financing in the form of bank loans for their start-ups constituted 21.2%. Those who applied for a bank loan following their start-ups constituted 32.4% while those who did not constituted 67.6%. SMEs. With regards to successful/unsuccessful bank loans applications, 34.7% of SMEs loan applications were rejected while the remaining SMEs (65.3%) bank loan applications were accepted. The SMEs preference to use Islamic bank was also examined and the result revealed that 90.9% were inclined to use it. While 9% were not.

A. Hypothesis Test on SME Preference Islamic Banking

To determine the Islamic banking preference, the respondents are grouped based on firm startup financing (bank loan/informal finance), bank loan application after the startup stage (applied/never applied for bank loan), and loan-application status (successful/unsuccessful). The Mann–Whitney test is employed to investigate the differences between the Islamic banking preferences of firms. The Mann–Whitney U test is an alternative non-parametric test used for t-test.

The Mann–Whitney U test is equivalent to the independent t-test and investigates the differences in the ranked position of scores in different groups. All hypotheses in this section are tested within the null hypothesis to eliminate differences in Islamic banking preference.

Firm starts up financing sources and Islamic banking preference.

H 1. Significant differences will exist between firms that started with conventional bank loan and started with informal financing in the preference to use Islamic banking.

The Mann–Whitney test is used to determine the differences between SME startup financing sources (i.e., bank loans or informal financing) in Islamic banking preference. Theoretically, startup firms with bank loan financing will continue to transact with their banks to build a strong relationship. A firm that has applied for and received a bank loan has ignored the religious factor because interest is prohibited in Islamic law. By contrast, startup firms that use informal financing have no relationship with any bank. Furthermore, the religious factor is important for these firms. Therefore, the religious factor is a motivating factor toward the use of Islamic banks. Based on this assumption, we observe that startup firms with conventional bank loans will be less likely use Islamic banks than startup firms with informal financing. Therefore, differences in Islamic banking preference exist between startup firms with different financing sources. Table I shows the results of Mann-Whitney test. The null hypothesis is rejected because the result for each variable tested indicates significant differences between startup

financing options and Islamic banking preference ($p < 0.0001$ (1%)).

TABLEI
MANN-WHITNEY TEST FOR FIRM STARTUP FINANCING AND ISLAMIC BANKING PREFERENCE

	Willing Use Islamic Bank
Mann-Whitney U	9226.000
Wilcoxon W	12229.000
Z	-4.472
Asymp. Sig. (2-tailed)	.000

a. Grouping Variable: sources of financing

SMEs that use informal financing in the startup stage prefer Islamic financing compared with SMEs that started with bank loans. SMEs that started with informal financing are reluctant to use loans with interests to financing their businesses. The religious factor is also more important for the SME at the startup stage with informal financing than SMEs that started with conventional bank loans. Therefore, the hypothesis (H1) is supported.

Firm financing sources after the startup stage and Islamic banking preference;

H 2. Significant differences will exist between firms that applied conventional bank loan for expansion and firms have never applied bank loan in the preference to use Islamic banking.

SMEs after the startup stage have better access to bank loans because of the availability of information and collaterals, as well as strong relationships with banks. However, SMEs after the startup stage usually use formal financing, which refers to bank loans. Theoretically, SMEs that have been using informal financing and are reluctant to access bank loans for the reason that loans come with interests (riba). By contrast, firms that have applied for bank loans have no problems with loans with interests (riba). Based on this assumption, firms that have applied for bank loans are less likely to use Islamic banking than firms that have never applied for bank loans. Therefore, firms with different financing sources have different perspectives on Islamic banking. The difference is further confirmed by the Mann–Whitney test in Table II.

TABLE II
MANN-WHITENEY TEST TO DETERMINE WHETHER A FIRM APPLIES FOR A LOAN OR HAS NOT IN DESIRE TO USE ISLAMIC BANKING

	Willing to use Islamic Bank
Mann-Whitney U	13185.000
Wilcoxon W	20206.000
Z	-2.844
Asymp. Sig. (2-tailed)	.004

The results from Table II shows significant differences between firms on whether apply for bank loans or not on Islamic banking preference ($p<0.0001$ (1%)). Therefore, the null hypothesis is rejected, and the study hypothesis (H2) is supported. SMEs that have never applied for bank loans have more preference to use Islamic banking than SMEs that have applied for bank loans.

Application loan status and Islamic banking preference.

H 3. Significant differences will exist between firms' loan application form successful and firms' loan application form unsuccessful in the preference to use Islamic banking.

The loan-application status can influence the firm to change banks or retain the same bank. Theoretically, firms with approved loan applications are likely to continue to transact with the same bank. By contrast, firms with disapproved loans will look for other sources of financing. Based on this assumption, we observe that a firm with an approved loan application has less desire to change banks and use Islamic banking than a firm with a disapproved loan application. Therefore, differences in loan-application status influence Islamic banking preference. Table III shows the results of the Mann–Whitney test. The null hypothesis is rejected because each variable tested indicates significant differences between the application status and Islamic banking preference at $p <0.0001$ (1%) significance. Therefore, the hypothesis *H3* is supported.

TABLE III
MANN-WHITNEY TEST TO DETERMINE WHETHER A FIRM APPLICATION LOAN STATUS IN ISLAMIC BANKING PREFERENCE

	Conversion from Gaussian and CG
Mann-Whitney U	1327.500
Wilcoxon W	4330.500
Z	-2.278
Asymp. Sig. (2-tailed)	.023

a. Grouping Variable: application status

In addition, to confirm validity of the results, researchers applied the alternative data analysis for non parametric to ensure the robustness of the results. Thus, chi-square Test for independence was selected in analyzing thus ensuring the robustness of results. The findings show a significant difference between firms which started with a bank loan and ones with the informal financing on their Islamic banking preference ($p<0.0001$ (1%). Result also shows a significant difference on Islamic banking preference between firms which apply for bank loans after startup with firms that do not ($p<0.0001$ (1%)). A significant difference between the application status and Islamic banking preference is also found at $p<0.0001$ (1%) significance. Therefore, the chi-square Test gave similar outcomes with that of Mann–Whitney test. These outcomes are enough to support all hypotheses. Therefore, three proposed hypotheses are supported, thus implying that significant difference in Islamic banking preference exists between firms that use informal financing and conventional bank loans as formal financing.

VI. CONCLUSION

This study found that, firms that have used conventional bank loans have less preference for Islamic banking than firms that have used informal financing. This result implies that firms that have used bank loans have strong relationships with conventional banks and are not religious. Thus, the possibility of such firms to use Islamic banks is less, whereas firms that

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have used informal financing are religious and have weak relationships with conventional banks. Therefore, the probability of such firms to use Islamic banks is high. The findings of this study can contribute to Islamic and conventional bank theories by the influence of the firm–bank relationship, that is, religious factor is not proven to have an influence on Islamic banking preference by firms that have used conventional bank loan.

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